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IN THE

Supreme Court of the United States

October Term, 1967

No. 1148

WALTER E. HELLER AND COMPANY

Petitioner,

v.

CHARLES C. SHAW, Trustee in Bankruptcy for BEMPORAD CARPET MILLS, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Of Counsel:

CHARLES L. GOWEN
WILLIAM H. IZLAR, JR.
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MICHAEL J. FREED

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above-entitled case on November 27, 1967.

CITATIONS TO OPINIONS BELOW

The opinion of the Court of Appeals, printed in Appendix A attached to this petition, *infra,* pp. A1-A12, is reported in 385 F.2d 353. The opinion of the United States District Court for the Northern District of Georgia printed in Appendix A, A13-A33, is reported in 258 F. Supp. 394.

JURISDICTIONS

(i) The judgment of the Court of Appeals was entered on September 14, 1967 (R. 210-21).

(ii) Rehearing was denied on November 27, 1967 (R. 267-70).

(iii) The jurisdiction of this Court is invoked under 28 U.S.C.A. § 1254(1).

QUESTION PRESENTED

Is a set off by a factoring company within four months of bankruptcy against a reserve account maintained by that company, a transfer of the bankrupt's property within the meaning of section 60a of the Bankruptcy Act, 11 U.S.C.A. § 96a.

STATUTES INVOLVED

The statutory provisions involved are § 60a of the Bankruptcy Act, 11 U.S.C.A. § 96a; § 60b of the Bankruptcy Act, 11 U.S.C.A. § 96b; and § 68a of the Bankruptcy Act, 11 U.S.C.A. § 108a. These sections are printed in Appendix B, *infra*, pp. B1-B2.

STATEMENT

The trustee in bankruptcy of Bemporad Carpet Mills, Inc., (Bemporad) brought an action in the district court against Walter E. Heller and Company (Heller) to recover approximately $287,000 of alleged preferential transfers arising out of a traditional factoring arrangement (R. 9-11). The district court in holding that Heller received no preferential transfers set forth detailed findings of fact and conclusions of law (Appendix A, *infra*, pp. A13-A34).[1] The Court of

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[1]Appendix A is hereinafter cited only to the page number.

Appeals for the Fifth Circuit reversed; a rehearing was denied on November 27, 1967 by a written opinion (A1-A12).

For eighteen months prior to bankruptcy Heller purchased accounts receivable from Bemporad under a factoring contract (A14). The transfers of accounts were perfected in accordance with applicable state law at or prior to the time of the transfer, and the question of perfection was not controverted nor is it an issue in the case. Under the factoring contract, Heller concurrently with the assignment of each account became obligated to pay a fixed purchase price at a fixed time (R. 198). The credit risk on each account was assumed by Heller (R. 198-99). Heller maintained a factoring reserve which represented the indebtedness owed by Heller to Bemporad on the purchase of the accounts.

Bemporad on its own credit was unable to acquire the bulk of its manufacturing inventory (A18, A23-A24). Before and during the four-months period immediately preceding bankruptcy, in order to obtain this inventory, Bemporad directed Heller to guarantee payment to suppliers of that inventory (A18). Immediately prior to shipment Heller guaranteed payment to the suppliers.[2] Each time Heller made a guaranty the factoring reserve was sufficient to cover the amount

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[2]The transactions were of two types. With respect to four of the suppliers, Heller first guaranteed payment and subsequently purchased the account receivable. These four suppliers were factoring customers of Heller and sold accounts receivable to Heller under a factoring contract virtually identical to Bemporad. With respect to one supplier, duPont, Heller did not purchase the accounts receivable upon which it had guaranteed payment.

of the guaranty. These transactions created a debt from Bemporad to Heller.

In due course after each payment to a supplier Heller set off its debt to Bemporad represented by the factoring reserve against the debt of Bemporad to Heller resulting from Heller's guaranties and payments to those suppliers (A19). Each set off was effected by a charge against the factoring reserve as contemplated and authorized by the factoring contract (R. 199). At the time of each set off the factoring reserve was sufficient to cover the amount of the set off.

These set offs against the factoring reserve are the transfers which the Trustee alleged and the Fifth Circuit held to be voidable preferences.

The basis of the Fifth Circuit's opinion is that while there were in existence debts of Bemporad to Heller arising from the guaranties, Heller received collections on the assigned accounts and made set offs against the factoring reserve. The court reasoned that these debts were "antecedent" to the collections and set offs, a fact which Heller had stipulated,[3] and concluded that

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[3]Originally the Fifth Circuit held that Heller had stipulated that the transfers of the accounts receivable were for an antecedent debt (A4). Heller's motion for rehearing vehemently attacked this interpretation of the stipulation (R. 223-52). Heller, in that motion, conceded that it had stipulated that the *charge* against the factoring reserve was to satisfy an antecedent debt (R. 225). The Fifth Circuit's opinion, in response to Heller's motion, denied that its opinion was based on a stipulation that the accounts receivable were transferred for an antecedent debt, (A11), but said that the "payments" (charge against the factoring reserve) "did relate back to the delivery over of the accounts" (A11-A12).

the collections and set offs were transfers for an antecedent debt.

The court then ruled that the collections and set offs were used to satisfy then existing debts and this "relate[d] back" and tainted the original underlying assignment of the accounts receivable making the assignment of the account a transfer for an antecedent debt. This decision was reached notwithstanding the uncontroverted fact that the accounts were assigned and transferred before the debts which were satisfied arose. Thus, in effect, the Fifth Circuit treated as decisive the time when the accounts were *collected* instead of the time when the accounts were *assigned*.

REASONS FOR GRANTING THE WRIT

I. The Fifth Circuit's Decision Conflicts With Decisions in Other Circuits Holding Set Offs Against Reserve Accounts Valid.

Section 68a of the Bankruptcy Act, 11 U.S.C.A. § 108a, permits a creditor of the bankrupt to set off against the bankrupt's debt any indebtedness owed by that creditor to the bankrupt. This provides a preference for a creditor over other creditors who do not have the availability of set off. Nevertheless, this type of preference is clearly sanctioned by this Court and by recognized authorities.[4]

(a) The decision of the Fifth Circuit in the present case is in direct conflict with *First Nat'l Bank v. Julian,*

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[4]See *New York County Nat'l Bank v. Massey,* 192 U.S. 138, 147 (1904); 4 W. COLLIER 68.16, at 778 (14th ed. 1967); 3 REMINGTON, BANKRUPTCY ¶ 1434, at 376-77 (5th ed. repl. vol. 1957). One commentator has characterized a section 68a transfer of property as a "legal preference." 3 W. COLLIER ¶60.15, at 827 (14th ed. 1967).

383 F.2d 329 (8th Cir.) *cert. denied,* 88 Sup. Ct. 593 (1967) which held that a creditor could set off against a reserve account other indebtedness owed by an insolvent to that creditor. In *Julian* an automobile dealer was selling his retail automobile paper to a bank. The reserve account was created in large part by the dealer having to deposit the difference in the interest it paid to the bank and the interest it charged to its customer. The Eighth Circuit held that the charge against the reserve account was not a transfer of property that constituted a voidable preference. By so holding, the Eighth Circuit recognized the legitimacy of a reserve account which the Fifth Circuit has denied. In the present case the Fifth Circuit found the charge by Heller against the factoring reserve account to be a voidable preference. The Fifth Circuit's position is in direct conflict with that of the Eighth Circuit.

(b) The decision of the Fifth Circuit is also in direct conflict with the Second Circuit's decision in *Wolf v. Aero Factor's Corp.*, 221 F.2d 291 (2d Cir. 1955), *affirming* 126 F. Supp. 872 (S.D.N.Y. 1954). In Wolf, the finance company which was lending on the security of accounts receivable would only advance 80 per cent on those receivables and retained 20 per cent.[5] The

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[5]There is basic distinction between factoring and accounts receivable financing. In factoring the person who acquires the accounts actually purchases them and by doing so assumes the *credit risk* of the debtors on the account. In accounts receivable financing, no credit risk is assumed; there is only a *loan* on the *security* of the assigned accounts. In *Wolf v. Aero Factor's Corp.*, 221 F.2d 291 (2d. Cir. 1955, *affirming* 126 F. Supp. 872 (S.D.N.Y. 1954), the court held that the creditor there involved, was not factoring, but was lending on the security of assigned accounts. See 126 F. Supp. at 882. For a general discussion of the distinction between factoring and accounts receivable financing see 1

Second Circuit held that the creditor could set off the funds it had collected (in what was tantamount to a 20 per cent reserve) and therefore owed to the bankrupt, against other indebtedness owed by the bankrupt to the creditor. See *Wolf v. Aero Factor's Corp.*, 126 F. Supp. 882-84 (S.D.N.Y. 1954), *aff'd*, 221 F.2d 291 (2d Cir. 1955).

(c) The decision in the present case is in direct conflict with the implied holding in *Porter v. Strevell-Paterson Fin. Corp.*, 292 F.2d 706 (10th Cir. 1961). In *Porter*, the trustee attacked the charge against a reserve account on the grounds that the finance company had not given him notice or demand for payment before setting off but the Tenth Circuit held that the finance company did not have to give such notice and left the set off standing as valid.

(d) The decision in the present case also conflicts with a well-reasoned and comprehensive opinion by a district court in the Ninth Circuit, *Pasadena Investment Co. v. Pasadena Air Prods. Inc.*, 234 F. Supp. 128 (S.D. Cal. 1964). While *Pasadena* is not a circuit court decision its fine analysis and similarity to the present case justifies bringing it to this Court's attention. In *Pasadena*, the bankrupt held contracts with two aircraft manufacturers. A factoring company agreed to purchase from the bankrupt all of the bankrupt's acceptable accounts receivable and in the process, purchased accounts receivable owing by the aircraft companies to the bankrupt. The court held that although the factoring company had advanced to the bankrupt

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G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 5.1-5.2 at 132 (1965); *Silbert Financing and Factoring Accounts Receivable*, 30 HARV. BUS. REV. 39, 41 (1952).

funds in excess of the amount then standing in the reserve account, thus putting the bankrupt in an overdrawn position, even this did not create an antecedent debt which would upon satisfaction be a preference because the finance company "being a debtor, could apply such amount of overdrafts as advancements upon future purchases under the continuing mutual factoring agreement." 234 F. Supp. at 134-35.

The decisions in the four circuits permitting a set off against a factoring reserve are in line with a host of decisions which have permitted a bank to set off under section 68a an insolvent's deposit against a debt owed to the bank by a bankrupt. See *e.g., New York County Nat'l Bank v. Massey,* 192 U.S. 138 (1904); *Citizens Nat'l Bank v. Lineberger,* 45 F.2d 522, 529-31 (4th Cir. 1930). A reserve account for the purposes of set off is essentially equivalent to a bank deposit; both are debts owed by the creditor the the bankrupt. None of those cases has questioned the right of the creditor to set off where it is clear that the creditor's debt is a genuine debt and not merely a masquerade for an unlawful payment by the bankrupt. In other words, in the bank cases, if the bankrupt made a genuine deposit which established a genuine debtor-creditor relationship between the bank and the bankrupt, set off is permitted. Set off will be denied, however, if the court finds that the transfer to the bank was not a genuine deposit but merely a payment. See *Blue v. Herkimer Nat'l Bank,* 30 F.2d 256, 259 (2d Cir. 1929), *cert. denied,* 281 U.S. 750 (1930).

The Fifth Circuit found that antecedent debts were paid by the transfer of accounts receivable rather than extinguished by a set off against a factoring re-

serve.[6] To reach this result the court said that the payments did "relate back to the delivery over of the accounts" (A12). Consequently, the Fifth Circuit found a payment for an antecedent debt rather than a valid factoring reserve even though there was no evidence in the record to suggest that the factoring reserve was not bona fide. Therefore, the holding that Heller was not entitled to set off its debt represented by the factoring reserve, which was a valid and bona fide debt, brings the present case into direct conflict with those circuits which have allowed set offs against valid reserve accounts.

At the heart of the Fifth Circuit's error is its insistence on treating the collections of the accounts receivable as the controlling incident in the entire transaction. This holding is contrary to existing law; where there is a valid assignment of accounts receivable collections on those accounts are not preferential. See *Sexton v. Kessler & Co.*, 225 U.S. 90 (1912); *Hughes v. Lawyers, Trust Co.*, 108 F.2d 792 (2d Cir. 1940); 3 W. COLLIER ¶ 60.48, at 1016 (14th ed. 1967).

Even if Heller had not collected one penny on the accounts assigned to it Heller would have still been

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[6]The Fifth Circuit in its original opinion seemed to indicate that Heller was arguing that even though Heller had received a voidable preference it could set off the amount of the bankrupt's debt against the Trustee's action to recover that voidable preference (A6-A7). Heller had never made this contention. However, in its opinion in response to Heller's motion for rehearing the court held that "by paying antecedent debts with accounts previously assigned to it [this is the setting off against the reserve account] Heller completed a transaction resulting in a voidable preference and hence was precluded from claiming a right of set off against the Trustee" (A12).

obligated to pay Bemporad for the accounts receivable which Heller had purchased. However, Heller would have also been able to set off its obligation represented by the factoring reserve against Bemporad's debt to it arising from the guaranties to the suppliers. In this connection it is important to realize that the factoring reserve was not comprised of collections. The collections on the accounts were irrelevant to a determination of the legitimacy of charges against the factoring reserve. Nevertheless, the Fifth Circuit, in an unprecedented holding, separated an account from the proceeds of that account, made the time of collection the determining factor in the case and thus invalidated an otherwise valid factoring reserve. In all of the four cases cited in this petition where the different circuits involved upheld the validity of charges against reserve accounts, the collections, just as in the present case, were subsequent to the creation of the bankrupt's debt and in none of those cases was that point controlling nor even discussed. The Fifth Circuit's decision in this case is clearly an aberation.

II. The Fifth Circuit's Decision Could Substantially Reduce the Availability of Factoring As a Source of Funds and It Produces Uncertainty in Conventional Commercial Relationships.

The total amount of factoring in the United States for the year 1967 was $8.993 billion dollars. *Daily News Record,* Feb. 5, 1968, at 1. (Fairchild Publication, New York, New York). Factoring had its origin in the textile industry. See Fig. I G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 5.1, 5.2, at 128-53 (1965). The factor was a significant element in that industry because "the small textile manufacturer has always needed financing and has always looked like

an unattractive risk to the banker." *Id* at 130. See generally Silbert, *Financing and Factoring Account Receivable,* 30 HARV. BUS. REV. 39 (1952). The factoring concern is obviously a substantial adjunct to the commercial finance industry and is principally used by small or moderate size businesses. The present decision if uncorrected could severely limit the availability of factoring as a source of funds for these businessmen.

The Fifth Circuit's decision also interjects uncertainty into established commercial practices. By holding that the time of collection of the account receivable establishes the time when the account is transferred the Fifth Circuit assumes a position contrary to section 9-106 of the *Uniform Commercial Code* (enacted in all states but Louisiana) which provides in part that "an 'account' means any right to payment for goods sold ...." Therefore an assignment of an account includes an assignment of the proceeds. This court in *Bank of Marin v. England,* 385 U.S. 99 (1966) stated that it would be unequitable to hold a bank liable for accepting and paying a check when it had no knowledge of the intervening bankruptcy of its depositor. Similarly, it is equally inequitable and subversive of predictable commercial practices to hold, as does the Fifth Circuit, that Heller's rights on accounts receivable for which it is exchanging valuable consideration are not fixed until the accounts are collected at some time in the future.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,
CHARLES L. GOWEN
Counsel for petitioner.

February 21, 1968

CERTIFICATE OF SERVICE

I hereby certify that I have this day mailed a copy of the attached petition with appendices to Clinton J. Morgan, attorney for the Respondent, at his business address with sufficient postage attached this 22d day of February, 1968.

CHARLES L. GOWEN
Attorney for petitioner

APPENDIX A

Charles C. Shaw, as Trustee in Bankruptcy
of Bemporad Carpet Mills, Inc.,
Bankrupt, Appellant,
v.
WALTER E. HELLER & COMPANY,
Appellee.
No. 24105.

United States Court of Appeals
Fifth Circuit.
Sept. 14, 1967.

Rehearing En Banc Denied Nov. 27, 1967.

Before RIVES and DYER, Circuit Judges, and JOHNSON, District Judge.

JOHNSON, District Judge:

Appellant, trustee in bankruptcy of Bemporad Carpet Mills, Inc., was denied relief by the district court in his plenary action to recover certain transfers made by the bankrupt to the appellee, Walter E. Heller & Company, which transfers were alleged to be either voidable preferences under Section 60a of the Bankruptcy Act or fraudulent under the provisions of Section 67d(2). The district court determined that all of the requisite elements of a voidable preference were conceded by the appellee or proved by the appellant. However, recovery was then denied on the basis that Heller established an affirmative defense to the trustee's action by proving itself to be a creditor who was at all times during the period in question fully secured. In addition, the district court found that Heller as a creditor-debtor of the bankrupt was entitled to set off the accounts as mutual debts and credits as provided by Section 68 of the Bankruptcy Act.

There is no question but that the evidence was substantial to support the finding that the trustee proved the elements necessary to establish the transfers as voidable under Section 60a. We are equally convinced that Heller's defenses thereto were not proved or sustained by the record and applicable law and hence should have been rejected by the district court.

I

Prior to the filing of its voluntary petition in bankruptcy on March 18, 1964, the bankrupt Bemporad Carpet Mills, Inc., was a carpet manufacturer at Fort Oglethorpe, Georgia. For some years it had suffered from financial difficulties, including a Chapter X reorganization proceeding which was dismissed in November, 1962. At that time, in order to secure funds for its continued operation, Bemporad gave Heller, a national concern whose business is factoring and otherwise financing businesses, a security deed on its real estate and equipment to secure the repayment of $430,000, $330,000 of which was advanced by Heller immediately, with the balance reserved to pay suppliers of Bemporad's raw materials.

On the same date, Bemporad and Heller entered into a factoring agreement whereby Bemporad would sell[1] "acceptable" accounts receivable to Heller. Heller would then credit the Bemporad account for the value of the accounts receivable and from time to time in its

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[1] Although the word "sell" is used here and by the parties, the ultimate results of the transactions in issue were not sales or purchases. Commercial Credit Corporation v. Sorgel, 274 F.2d 449, 466 (5th Cir. 1960).

discretion would make payments to Bemporad out of this account. Heller also had factoring arrangements with four of Bemporad's suppliers of raw materials. Before any of these suppliers would ship to Bemporad, a guarantee of payment was obtained from Heller by the supplier, and either at that time or a later date Heller would purchase the invoices evidencing the shipment. In addition to the guaranties and purchases made by Heller for these four suppliers, Heller guaranteed payment for raw materials sold Bemporad by the E. I. DuPont & Company, which company was not a client of Heller's.

During the four months' period immediately preceding the date of the filing of the bankruptcy petition, which period extends from November 19, 1963, to March 18, 1964, Bemporad transferred to Heller over $700,000 in accounts receivable. This created an account in favor of Bemporad which, according to the accounting procedures of Heller, showed a balance due Bemporad throughout the critical period. The amount in issue, $287,524.91, is the credited value of the accounts receivable which the trustee urges were transferred under such circumstances as would give rise to a voidable preference and is the sum the trustee asserts Heller paid itself to the detriment of other general creditors, the ultimate effect of which was to deplete the bankrupt's estate.

During the bankruptcy proceeding, Heller sold the security described in its security deeds for $479,820.57. After applying a portion of this to debts due it from Bemporad and deducting various charges, which are not questioned here, there remained $12,714.31, which Heller now tenders to the trustee as being all that it owes the estate. The trustee objects and reasons that

the $12,714.31 has been created by Heller's having previously applied the aforesaid accounts receivable in the amount of $287,524.91 to the payment of antecedent debts owed by Bemporad to Heller.

One of the recognized methods of valuation of security in bankruptcy is the conversion of the security into money by sale according to the terms of the contract and/or as may be approved by the court. Sec. 57h of the Bankruptcy Act. In this case the value of Heller's collateral was determined when it was sold for $479,820.57. To this extent, and no more, Heller was secured. The district court's determination that Heller was at all times a fully secured creditor is in error. Heller was made whole only by setting off the $287,524.91 accounts receivable, the validity of the transfer of which is the very question to be decided by the Court. While Heller may have felt secure, the secured status of a creditor in bankruptcy is more than a state of mind or a method of accounting.

As stated in the opinion of the district court, the transfer of accounts receivable is not in itself preferential or fraudulent if the filing statutes are complied with and the accounts are transferred for a present consideration, but here the record unquestionably reflects that these transfers were stipulated by the parties to be made in payment of antecedent debts.

Is is by reason of the future advance clauses in the security agreements that Heller is secured to the extent of $479,000, Hulsart v. Hooper, 274 F.2d 403 (5th Cir. 1960), since it appears that the specific amounts due under the notes and mortgages were less. The trustee does not take issue with Heller's right to the full $479,000 received upon sale of the security, and it is not necessary for this Court to de-

termine whether the supplier accounts and invoices guaranteed and purchased by Heller may be tacked on as future advances allowable under Georgia Code Section 67-1316. Thus, up to the amount of $479,000, the district court was correct in its conclusion as to the effect of "cross collateral future advance provisions contained in each of the security agreements." But the district courts general conclusion that the transfer of the accounts receivable, where all the requisite elements of a voidable preference were present, was the "giving of security by Bemporad to Heller prior to or concurrently with guaranties or commitments by Heller is not a preference under section 60 of the Bankruptcy Act" is not in accord with the facts in this case and must necessarily be in reference to transactions between the parties which are not in issue here.

If the transfer of these accounts could be called the giving of additional security—and we think it was not[2]—there is no support in the record for any theory that they were given "prior to or concurrently with." In this connection, it is appropriate to emphasize that all of the transactions here involve the satisfaction of antecedent debts. The giving of new or additional security under such circumstances, where the other elements of a voidable preference are present, would not relieve such transactions from being voidable by a trustee in bankruptcy. In re Pusey, Maynes, Breish Co., 122 F.2d 606 (3d Cir. 1941); Small v. Williams, 313 F.2d 39 (4th Cir. 1963). See 3 Collier, Bankruptcy, § 60.21 (1966).

[2] Under Georgia Code Section 67-103, which was in effect at the time of the execution of these security agreements, property which may be embraced in such must be in existence or be one of those items described in the statutes. Accounts receivable are not among the items includable.

II

Appellee's contention that it was entitled to set off the accounts under Section 68 of the Bankruptcy Act, while not determinative in the district court's ruling in view of the finding that Heller was at all times a fully secured creditor, must be dealt with here since such right of set-off, if established, would preclude recovery by the trustee. The record reflects that Heller set off against the Bemporad account, created by the transfer of the accounts receivable, payments made by Heller to the suppliers on invoices guaranteed and purchased. That this accounting procedure involved mutual debts and credits and effected a set-off in a general sense is apparent. It would appear from the surface to be the type of transaction which the statute contemplates. As pointed out by the district court in its opinion, Section 68 of the Bankruptcy Act does give a creditor who holds a set-off position an advantage. But by application of Section 68b(1) this advantage is available only to a creditor who has a claim that can meet the requirements of 57g of the Bankruptcy Act. This section provides that the claims of creditors who have received preferences shall not be allowed:

> "The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under this Act, shall not be allowed unless such creditors shall surrender such preferences, liens, conveyances, transfers, assignments, or encumbrances."

It follows that a creditor may not defend against the receipt of otherwise voidable preferences by asserting the right of set-off under Section 68, but,

to the contrary, must prove himself to be free of such. Walker v. Wilkinson, 296 F. 850 (5th Cir. 1924); Bennett v. Rodman & English, Inc., 2 F.Supp. 355 (E.D.N.Y. 1932), aff'd per curiam 62 F.2d 1064 (2d Cir. 1932). See 4 Collier, Bankruptcy, §§ 68.08, 68.09 (1966). The advantage referred to by the courts and text writers,[3] and which is urged upon the Court by appellee, comes into play where a debtor-creditor of a bankrupt's estate may by setting off mutual debts or credits in effect pay himself, which payment if made by the bankrupt where all of the other requisite elements were present would constitute a voidable preference. Unfortunately for appellee, the transactions here involve more than matters of book entries. The payments were made by the bankrupt in the form of the transfer of accounts receivable, which were in turn applied against antecedent debts, at a time when appellee knew or had reason to believe that the bankrupt Bemporad was insolvent, the effect of which was to enable Heller to obtain a greater percentage of its debt than other creditors of the same class and which depleted the estate to the detriment of other general creditors.

That Heller in the position of a guarantor was a creditor who could be charged with the receipt of voidable preference has been pointed out by this Court's recent opinion in Cooper Petroleum, et al. v. Hart, et al., 379 F.2d 777 (5th Cir., June 29, 1967). In the *Cooper* case, as here, there were continuing transactions between the parties during the four months' period preceding bankruptcy, the results of which

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[3] For an example of such statements, see 3 Remington, Bankruptcy § 1434.5 and authorities therein cited.

were the flow of goods to the bankrupt and payments made back from him on same. Our reasons for refusing to apply the so-called "net result" rule in the *Cooper* case are equally as applicable and compelling here.

The purpose of Section 60a is to create an insulated four months' period during which all creditors of the same class must be dealt with equally. While it may be conceded that there is a necessity for the existence of businesses who factor accounts and advance money to enterprises in financial difficulty—and perhaps in some instances they save such businesses from failure—these services do not entitle factors or others to exemption from the application of the provisions of the Bankruptcy Act. It might be argued that the converse should be true since such concerns are usually on the "inside" of the operation and thus have full knowledge of the situation out of which arise the circumstances they later seek to avoid.

Any appeal for the application of equitable principles can best be answered by Mr. Justice Harlan's statement in Bank of Marin v. England, 385 U.S. 99, 106, 87 S.Ct. 274, 17 L.Ed.2d 197 (1966) (dissenting opinion):

> "The Court's principal contention seems to be that equitable considerations oblige it to release the bank from liability. Its premise plainly is that equity is here a solvent to which we may appropriately resort; I am unable to accept that premise. This is not a case in which the statute is imprecise. Nor is it a case in which the legislature's intentions have been misshapen by the statute's words; even a cursory examination of the history

of § 70 will evidence that its terms faithfully reflect Congress' purposes."

The judgment of the district court is reversed and the case is remanded for the entry of a judgment for the trustee.

RIVES, Circuit Judge (specially concurring:)

I agree with the district court that the accounts receivable assigned by Bemporad to Heller pursuant to their factoring agreement[1] furnished Heller additional security against liability for Bemporad's supplies purchased or guaranteed by Heller. Even so, however, I think that Heller is bound by the value of its other security established by the foreclosure sale some six weeks after the date of bankruptcy as opposed to the previous theoretical or opinion values.[2] With value of the security so fixed, it cannot be said that Heller was a fully secured creditor during the critical four months prior to bankruptcy.

Aside from the question of security, I am impressed by the district court's view that "* * * there is considerable basis for holding that the payments were not preferential or, in the alternative, entitled to set off. It can be argued that there was a present consideration in that almost concurrently with the furnishing

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[1] Part of this agreement provides: "Any amounts owing by you to us for merchandise purchased from any concern factored or financed by us, or for commissions, interest, etc., may, at our option, at any time be considered as advances against your sales accounts and chargeable to you."

[2] Palmer Clay Products Co. v. Brown, 1935, 297 U.S. 227, 229, 56 S.Ct. 450, 80 L.Ed. 655; Canright v. General Finance Corp., 7 Cir. 1941, 123 F.2d 98.

of assets (i. e. raw materials) to the bankrupt, payment was made to the supplier with the bankrupt's own funds. Mere delays in payment do not normally render the transfer of funds a payment on an antecedent debt. The purchases of raw materials by the bankrupt were in essence cash transactions, with a delay occasioned only by furnishing the payment through Heller. 8A C.J.S. [Bankruptcy] § 220(1) at page 100. Engstrom v. Wiley, 191 F.2d 684 (9th Cir. 1951). The court has a duty to consider whether the parties' intention was to make a cash sale or an extension of credit. Unquestionably during the four-months period the suppliers would not extend credit to Bemporad, nor would they ship until Heller assumed the payment of the invoices. Thus, in equity, there is considerable basis to conclude that there was no antecedent debt; and, further, that no depletion of assets of the bankrupt occurred through the transfers of cash credits for raw materials received."

It seems to me, however, that this preference action is governed by Section 60 of the Bankruptcy Act and not by general principles of equity.[3] The record shows Heller's payments for supplies out of the Bemporad account during the four-month period were not cash payments but were for supplies previously furnished and for which Heller had either assumed primary liability or had guaranteed payment. Thus the payments were for antecedent debts and had all the elements of a voidable preference under Section 60. In my opinion, the evidence did not show either that Heller had a

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[3] Schoenthan v. Irving Trust Co., 1932, 287 U.S. 92, 53 S.Ct. 50, 77 L.Ed. 185; Corn Exchange National Bank & Trust Co. v. Klauder, 1943, 318 U.S. 434, 437, 63 S.Ct. 679, 87 L.Ed. 884.

legal right of setoff or that it was a fully secured creditor. I therefore concur in the result.

PER CURIAM:

Walter E. Heller & Company seeks a rehearing upon the determination of this Court in this case of the issues adverse to the contentions Heller & Company advanced. In addition, and as authorized by the appropriate rule of this Court, Heller requests that it be granted a motion for rehearing en banc so that the questions presented can be disposed of by the Court sitting en banc.

Heller's contention, in its application for a rehearing, that this Court and the District Court were dealing with two distinct transfers is erroneous. We were deciding whether there was a transfer under § 60a of the Bankruptcy Act which resulted in a voidable preference. Heller's insistence that this Court based its ruling upon a stipulation that the delivery over or assignment of accounts to Heller was in satisfaction of an antecedent debt is likewise erroneous. Bemporad delivered over to Heller some $700,000 in accounts during the four-month period preceding bankruptcy. $287,000 of these accounts was stipulated by Heller to have been applied on antecedent debts. Although Heller prefers to call the fund from which the $287,000 came a "factoring reserve," it was made up of accounts receivable of Bemporad delivered over to Heller during the four-month period. This delivery over or transfer, or whatever it might be called, when coupled with the application of accounts to antecedent debts, resulted in a transfer under § 60a. Once Heller stipulated that these accounts received within four months were used to pay antecedent debts, the trans-

fer was completed and would and did relate back to the delivery over the accounts.

At all times in this case Heller relied on affirmative defenses. What it states in its motion to be misconception of the facts would not and did not keep Heller from proving these defenses if they were available.

Heller's argument, in its rehearing motion in support of its defense of setoff, is likewise without merit. This argument is to the effect that the Court found that the transfer of accounts receivable was a voidable preference and its setoff defense was thus cut off without proper consideration. The true situation is that this Court found that by paying antecedent debts with accounts previously assigned to it, Heller completed a transaction resulting in a voidable preference and hence was precluded from claiming a right of setoff against the trustee. As appellant trustee stated in an argument, "set off what?" Heller had paid itself. All it had to claim as a setoff under § 68 is this payment which the Court finds to be a voidable preference and which it is, consequently, forbidden to claim by § 68b.

It is, accordingly, ordered that the petition for rehearing be and the same is hereby denied and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, Rule 25a, subpar. (b), the petition for rehearing en banc is

Denied.

Charles C. Shaw, as Trustee in Bankruptcy
of Bemporad Carpet Mills, Inc.,
Bankrupt, Plaintiff,

v.

WALTER E. HELLER & COMPANY,
Defendant.

No. 9149.

United States District Court
N. D. Georgia,
Atlanta Division.

June 21, 1966.

PRELIMINARY STATEMENT AND FINDINGS

SIDNEY O. SMITH, Jr., District Judge.

This is a suit in which the plaintiff Trustee in Bankruptcy seeks to recover as alleged preferential transfers some $295,298.89 passing to the defendant factor from the bankrupt manufacturer during the four-months period preceding adjudication in bankruptcy. The Trustee contends that all of such transactions constitute preferences under Section 60 of the Bankruptcy Act (11 U.S.C.A., § 96).

As background, it is necessary to understand that the defendant factor had done business with the bankrupt and its predecessor (Croft Carpet Mills, Inc.) over several years.

On June 26, 1962, Bemporad (then "Croft Carpet Mills, Inc.")filed a petition for reorganization under Chapter X of the Act. The reorganization proceeding was dismissed after Bemporad arranged through financial commitments from Heller and others to satisfy its creditors.

On November 13, 1962, the financing arrangements with Heller were approved by the reorganization Court and provided a line of credit of $430,000. for Bemporad of which $330,000. was immediately loaned, the balance to be available for commitments and payments by Heller to Bemporad's suppliers to induce them to ship raw materials to Bemporad. To secure this line of credit Bemporad concurrently gave Heller a security deed upon its real estate and equipment, which security deed was duly recorded under State

law.[1] Tufted Rug Mills, Inc., a subsidiary of Bemporad, guaranteed all indebtedness owing from Bemporad to Heller. This guaranty was secured by a security deed upon Tufted's real estate which security deed was duly recorded.

On November 13, 1962, Bemporad and Heller entered into a factoring agreement[2] which provided that

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[1] Besides securing the real estate and machinery loan of $330,000. the security deed provided:

Grantor expects to become or may become indebted from time to time, at Grantee's discretion, for various additional sums of money to be advanced by way of loans, endorsements and/or other forms of indebtedness, or obligations arising out of financing arrangements between Grantor and Grantee, or otherwise (hereinafter referred to as "advances") to be used or resulting from or arising out of the conduct of Grantor's business. This conveyance is made also for the purpose of inducing Grantee to make such advances and to secure and make certain the payment by Grantor to Grantee of all such advances and any notes or instruments evidencing the same, or any other obligations, howsoever and whensoever arising from Grantor to Grantee, together with interest thereon made, created, accruing or owing by Grantor to Grantee, within the period of any time during which Grantor for any reason whatsoever may be indebted or obligated to Grantee, and also any other indebtedness of whatever kind or character, whether otherwise secured or not, that may be owing by Grantor to Grantee, up to the date of the foreclosure of his conveyance; provided, however, that the aggregate amount secured hereby, including the balance, if any, on the above-described note shall at no time exceed the sum of Four Hundred Thirty Thousand Dollars ($430,000.00).

[2] Part of this agreement provides: "Any amounts owing by you to us for merchandise purchased from any concern factored or financed by us, or for commissions, interest, etc., may, at our option, at any time be considered as advances against your sales accounts and chargeable to you."

Bemporad would sell acceptable accounts receivable ble to Heller. Notice of assignment of accounts receivable was duly filed under State law. Pursuant to the factoring agreement, Bemporad delivered to Heller numerous schedules and assignments of accounts receivable, almost on a daily basis. The schedules and assignments contained language tying the accounts receivable to any other obligation or agreement between the parties.[3]

On December 19, 1962, to enable Bemporad to purchase a Supertufter, Heller loaned Bemporad $96,-639.75[4] (including interest added) secured by a bill of sale to secure debt on the Supertufter which was duly recorded.

On August 8, 1963, Heller loaned Bemporad $100,-079[4] secured by negotiable warehouse receipts covering jute.

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[3] All assignments of accounts receivable provide: "All our representations, warranties, agreements, undertakings and obligations herein or in any other existing or future agreement with the Assignee contained, or otherwise expressly or impliedly assumed or undertaken by us, and all rights, powers, privileges and remedies of the Assignee under or in respect thereof, shall be deemed cumulative and continuing and not in limitation, substitution, derogation, release or discharge of any one for any other, and none thereof is exclusive; and no failure or delay of the Assignee to exercise or enforce any thereof, or to insist on strict compliance with or performance by us of any thereof, shall operate as a waiver, modification, release or discharge thereof."

[4] All notes of Bemporad to Heller provide: "To secure the payment of the principal and interest of this note and all renewals and extensions of the same or any part thereof and any and all other sums, indebtedness and liabilities

From the inception of the factoring arrangement to the date of bankruptcy, Heller and Bemporad were engaged in two principal activities. One was the continuous purchasing by Heller of substantially all of Bemporad's accounts receivable, which aggregated $703,720.67 during the four months period.[5]

There is no contest here that the collection by Heller of the accounts receivable purchased for a present consideration constituted a preference. Such assignment and collections, even though they occur within the four-months period do not result in voidable preferences. 8A C.J.S. Bankruptcy, § 217(4) at 70; Wolf v. Aero Factors Corp., 221 F.2d 291 (2nd Cir. 1955); Doggett v. Chelsea Trust Co., 73 F.2d 614 (1st Cir. 1934). Compare Blackford v. Commercial Credit Corp., 263 F.2d 97 (5th Cir. 1959), where there was no present consideration. Likewise, authorized charges may be made against a reserve account without creating a preference. Porter v. Strevell-Paterson Finance Corporation, 292 F.2d 706 (10th Cir. 1961). The difficulty arises by virtue of the fact that Heller did not remit the advances to Bemporad for receivables purchased, but simply credited, as is customary in the trade, the amounts in an "Account Current,"

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now or hereafter owing or to become owing from the undersigned to the payee, or the holder hereof, howsoever created, arising, evidenced or acquired by said payee or holder, whether direct or contingent, the undersigned has assigned, pledged, deposited and delivered to the payee the following (hereinafter called 'Collateral'):"

[5] The entire record of debits and credits, outside of foreclosure following bankruptcy, is best understood by the details of Defendant's Exhibits II and JJ, hereby made a part of these findings.

showing a running balance and reserves in favor of Bemporad throughout the period in question.

The other primary activity of Heller was the effecting of arrangements with suppliers to ship raw materials to Bemporad. Bemporad frequently requested Heller to provide assurance of payment to five of its suppliers in order to obtain raw materials.[6] Four of these suppliers (Burkhart-Schier; Pharr Yarns; Fulton Cotton Mills; Painter Carpet Mills) were factoring clients of Heller having factoring agreements similar to Bemporad's and Heller purchased, without recourse, invoices arising out of shipments to Bemporad by those suppliers. As to the remaining supplier, DuPont, Heller did not purchase the account, but guaranteed the account. In either

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[6] Several times such oral request and direction was given. On October 23, 1963, Bemporad's President, Allen, wrote two letters of authorization to Heller. The body of such letters provided:

(1) "You are authorized to make payments due on our accounts payable from the proceeds of our factored sales.

This procedure will be of great assistance to us, and we trust that it will not greatly complicate the transactions with your company."

(2) "In connection with the chattel mortgage payments due by us, you are authorized to make these payments from the proceeds of our factored sales, and the payments made on October 14th of $5,500.00 each are specifically approved.

You are also authorized from time to time to make payments on the equpiment note in the amount of $1,610.66, and two payments you recently made in this fashion are approved.

Your assistance in handling these transactions in the manner authorized above is greatly appreciated, and we hope that this does not cause you any inconvenience."

case, payment was effected by transfer from the account current. The purchase of supplier's invoices and the guaranty of DuPont invoices was a continuing business decision made by Heller, based on its entire "security" position, including the status of the real estate note, chattel mortgages, and the condition of the account current. During the four-months period the total advances and commitments which Heller honored totaled $702,382.55.

The Trustee contends that the application of funds in the account current during the four-months period for payment to these third parties on obligations assumed by Heller resulted in preferences to Heller. While there are other smaller claims, these two types of transactions constitute the bulk of this suit as follows:

Supplies accounts purchased	$118,581.56
DuPont accounts guaranteed	127,710.71
	$246,292.27

Thus, the primary problem is the determination of the issue of preference in these two categories. The case was extensively tried non-jury. Prior to trial there was considerable discovery and stipulation in an effort to reduce the complexity of so many transactions and to narrow the issues as much as possible. Considering the substantial activity of factors in today's economy and while counsel on both sides ably prepared and presented the case, there is a surprising dearth of specific authority on the questions presented.

At the outset it was conceded that all of the prima

facie elements[7] of a preferential transfer were present save (1) insolvency and (2) reasonable cause to believe insolvency; and if the Trustee carried the burden of proof on these two issues the payments would constitute preferences unless some matter of defense prevented such conclusion. The primary defenses presented were (1) the right of set-off under Section 68 of the Bankruptcy Act (11 U.S.C.A. § 108) and (2) the secured position of Heller by virtue of open-end clauses and cross-collateralization provisions of its factoring agreements and mortgages.

FINDINGS OF FACT

On March 18, 1964, Bemporad Carpet Mills, Inc., filed a voluntary petition in bankruptcy in the United States District Court for the Northern District of Georgia, Rome Division, and was on said date adjudicated a bankrupt.

The four month period immediately preceding the date of bankruptcy extends from November 19, 1963, to March 18, 1964.

On June 30, 1963, the balance sheet of Bemporad and statement of operations for the fiscal year ending on that date showed an insolvent position of $106,778. and an operating loss of $358,742., and the company was in fact insolvent on that date. On December 14, 1963, according to its statement Bemporad was insolvent by $581,437. As of November 16, 1963, Bemporad was insolvent by at least $500,000. Even if the highest market value of the fixed assets of the corporation,

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[7] See Mayo v. Pioneer Bank & Trust Co., 5 Cir., 270 F.2d 823; 8A C.J.S. Bankruptcy, § 213 at page 4.

such as realty and machinery, are used instead of the cost-less-depreciation figures used on the June 30 and December 14 statements, Bemporad was insolvent on November 16, 1963, by at least $200,000.

Heller concedes that it had reasonable cause to believe insolvency as of January 9, 1964, when its officers reviewed the December 14th statement with other creditors.

From the beginning of the four month period on November 19, 1963, to the date of the first charge that was made against the Bemporad account on December 9, and up to January 9, 1964, Heller had reasonable cause to believe that Bemporad was insolvent, by reason of the following:

The financial arrangements under which Bemporad came out of the Chapter X proceedings in November, 1962, were the personal creation of Thomas E. Neal, senior Vice-President of Heller, who was familiar with the financial condition and operations of Bemporad prior to that time and continuously after that time. In fact, he recommended the hiring of Ross Allen, President of Bemporad and its chief executive officer from the time of reorganization until bankruptcy. Neal is very knowledgeable in the financial end of carpet manufacturing and also in marketing, and for the year preceding the four-months period he knew as much or more than management regarding Bemporad's true financial condition and prospects.

In April of 1963, Heller knew that DuPont refused to extend any credit to Bemporad due to Bemporad's poor financial condition.

Heller knew in September of 1963 that none of the suppliers factored by it would ship merchandise to Bemporad without first calling Heller and obtaining a guarantee of payment.

Eight times during 1963, for the months of May through December, Bemporad was past due in paying the Heller real estate note.

Ten times during 1963, for the months of March through December, Bemporad was past due in paying the Heller supertufter note.

On July 1, 1963, Heller advised Bemporad by letter that the June payments on the two mortgage notes were past due; and on July 10, 1963, Heller advised Bemporad by letter that payments owing to Heller on certain Pharr Yarns invoices were past due.

On September 3, 1963, Heller was notified that a $10,000. check issued to Heller by Bemporad had been dishonored by the drawee bank because of insufficient funds.

Two days later, on September 5, 1963, Thomas E. Neal, senior vice-president of Heller, and Ross Allen, president of Bemporad, entered into an agreement whereby Bemporad authorized Heller to pay DuPont and to immediately charge such payment against the Bemporad account and to also charge this account for indebtedness due to Heller on the various collateral notes.

On September 6, 1963, Heller received the Bemporad balance sheet and statement of operations for the fiscal year ending June 30, 1963, which was certified by a firm of certified public accountants as pre-

senting fairly the financial position of Bemporad and which showed an insolvency.

The monthly interest payments due on the real estate note for October, November and December of 1963 were not paid until January 13, 1964, although due on the 13th day of each month.

Heller and Bemporad had been engaged in a close business relationship for a period of one year (November, 1962 to November, 1963), Heller had a total debt of $594,605.41 owed to it by Bemporad as of November 18, 1963, and Heller had full opportunity to obtain knowledge of Bemporad's financial condition.

In July of 1963 Thomas E. Neal prepared a memorandum which set forth his opinion that Bemporad "will suffer further losses" because of the company's merchandising policy.

Neal knew of the poor volume production of Bemporad in the spring of 1963. Neal and Allen had frequent telephone and personal conferences about the overall financial condition of Bemporad prior to the four-months period and Neal knew from the receivables purchased by Heller that sales were poor, considering the size of Bemporad.

Initially (November, 1962), payments to suppliers and DuPont were made direct by Bemporad either with its own funds or funds advanced by Heller to it for that purpose. Later, they were paid by Heller with funds furnished it by Bemporad.

In the early fall of 1963, when Bemporad's financial position became more critical, agreements were entered into whereby the suppliers and DuPont were paid by

Heller and such payments immediately charged to Bemporad's account current, instead of awaiting a check to Heller from Bemporad.

On each day during the four months period, the total value of the outstanding accounts receivable purchased by Heller and of the collateral, upon which Heller had a lien and security interest, exceeded the total indebtedness of every kind owing from Bemporad to Heller on that day. On December 10, 1963, the total indebtedness owing by Bemporad to Heller was overstated on the books and records of Heller by $43,780.44 because of a one day delay in posting a part of the entries pertaining to supplier payments.

In January, 1964, after receipt of the December 14, 1963, statement, a meeting was arranged in Chicago by Heller and attended by various representatives of Bemporad's major creditors, including unsecured creditors such as Allied Chemical. At the meeting Neal gave the opinion that Bemporad would go under unless steps were made to rescue the operation. As part of the proposal, Heller agreed to furnish additional working capital by the purchase from Bemporad of certain substandard accounts which it had heretofore been unwilling to purchase. Under the original factoring agreement, Heller purchased accounts receivable without recourse and immediately became obligated to pay a purchase price equal to the face of the accounts receivable, less minor adjustments. Heller assumed the credit risk on such accounts and had no recourse against Bemporad except for breach of warranties by Bemporad that there were no disputes or counterclaims by its customers. In effect, the account current was subject only to such "disputations."

In January, 1964, the substandard accounts were

purchased with recourse and the entire credit and collection risk of such accounts was on Bemporad. As a bookkeeping expedient such accounts were maintained as the "S account" by Heller. The "S" accounts were scheduled and assigned to Heller on the same form of schedule and under the same factoring agreement as the regular accounts. The acquisitions by Heller of "S" accounts were posted on a separate ledger but Heller's advances on the "S" accounts were not segregated from advances on the regular account and were posted only to the regular account ledger.[8] On March 10, 1964, the "S" account ledger showing a balance of $67,711.77 was consolidated with the regular account ledger. Heller collected $33,151.46 on the "S" accounts. The remaining uncollected accounts totaling $41,224.59 were, during the course of liquidation, charged against Bemporad since Heller had previously given Bemporad full credit of $74,376.05 for the total amount of all "S" accounts acquired.

The indebtedness owing by Bemporad to Heller outstanding on the date of bankruptcy has been paid in

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[8] The trustee places great emphasis on this separate account, contending that credits for advances thereon were not posted to the "S" account.
As some $33,721.16 of the substandard accounts were collected by Heller, the Trustee contends that the debtor is due such additional sum in this suit. However, the evidence shows that credits for all such accounts ($74,376.05) were posted to the regular account current, and charged back for the $41,224.59 not collected. For all practical purposes, there was only one customer with various debits and credits. Until bankruptcy, the recourse accounts were maintained separately for obvious accounting benefits. As there was present consideration for the purchase of the $33,-721.16, no preference arises here any more than from any other direct purchase of accounts receivable.

full through the liquidation by Heller to its collateral and accounts receivable. After the commencement of the Bemporad bankruptcy proceeding, upon the authority of the Referee in Bankruptcy, Heller foreclosed its liens and security interests upon all real estate and equipment in a commercially reasonable manner and sold such collateral for $500,000. After giving Bemporad due credit for all the proceeds of liquidation there is now a final credit balance held by Heller of $12,714.31 which Heller has tendered to the Court for disposition.

In order to obtain payment of past-due interest on its real estate loan to Bemporad, Heller charged the Bemporad account as follows:

Date Charged	Amount Charged	Interest Due Dates
Jan. 13, 1964	$9,302.04	Oct., Nov. & Dec. 1963
Feb. 4, 1964	3,109.31	Jan., 1964
Mar. 10, 1964	2,874.11	Feb., 1964
	$15,285.46	

and such charges are also attacked as preferences in addition to the main claims totaling $246,292.27.

CONCLUSIONS OF LAW

As can be seen, the court has determined that the bankrupt was hopelessly insolvent during all of the period in question. In this connection, even under the "balance sheet" test, the bankrupt's actual, rather than threatened, condition at the time, determines the question of insolvency. Mitchell v. Investment Securities Corp., 67 F.2d 669(5) (5th Cir. 1933).

[4-6] Under the rules applicable in this circuit, the question of reasonable cause is to be determined by the facts in each case. Thus, "Cases on the point have evolved a fine line to apply in determining whether a creditor has 'reasonable cause to believe' that a debtor is insolvent. For reasonable cause to exist, it is not necessary that a person benefitted by a transfer know positively that the result of the transaction will be to effect a preference: it is sufficient for a finding of reasonable cause that the person or his agent has knowledge of such facts as would induce a person of reasonable prudence to make inquiry, when such inquiry would have developed the facts essential to a knowledge of the situation. On the other hand, if the known facts should raise only a suspicion that the debtor might be insolvent, the test is not met. Compare Marks v. Goodyear Rubber Sundries, 2 Cir., 1956, 238 F.2d 533, 62 A.L.R.2d 770 with Lang v. First National Bank in Houston, 5 Cir., 1954, 215 F.2d 118. See 3 Collier on Bankruptcy, § 60.53." Mayo v. Pioneer Bank & Trust Company, 297 F.2d 392 at 394, 395 [1, 2] (5th Cir. 1961). See also Mizell v. Phillips, 240 F.2d 738 at 741(10) (5th Cir. 1957). Under the overwhelming evidence in this case, if indeed Heller did not have actual knowledge of insolvency, it was at least put on notice to make an ordinarily diligent inquiry which would certainly produce knowledge of the insolvency which existed. See Collins v. Bank of Titusville, 36 F.2d 482 (5th Cir. 1929). The fact that Heller considered itself "secured" diminishes in no way its need for diligence nor does it produce a different standard of reasonable cause from that of an "unsecured" creditor. See Clower v. First State Bank of San Diego, 5 Cir., 343 F.2d 808.

Under the rules applicable in this circuit, the reached directly. The doctrine of "set-off" is often considered as a question of "non-preference" of a particu-

lar fund rather than a strict technical accounting matter, with the result that the problem is frequently approached from both directions by the courts. Thus a determination of "non-preference" is sometimes called a "set-off", and vice-versa. Walker v. Wilkinson, 296 F. 850 (5th Cir. 1924). Also, in considering such questions, the court sits in equity and should exercise its discretion under all the facts and circumstances of each particular case. E.G. In re Rosenbaum Grain Corp., 103 F.2d 656 (7th Cir. 1939).

Considering the question in such light and omitting the question of security for the purpose, there is considerable basis for holding that the payments were not preferential or, in the alternative, entitled to set-off. It can be argued that there was a present consideration in that almost concurrently with the furnishing of assets (i. e. raw materials) to the bankrupt, payment was made to the supplier with the bankrupt's own funds. Mere delays in payment do not normally render the transfer of funds a payment on an antecedent debt. The purchases of raw materials by the bankrupt were in essence cash transactions, with a delay occasioned only by furnishing the payment through Heller. 8A C.J.S. 220(1) at page 100. Engstrom v. Wiley, 191 F.2d 684 (9th Cir. 1951). The court has a duty to consider whether the parties' intention was to make a cash sale or an extension of credit. Unquestionably during the four-months period the suppliers would not extend credit to Bemporad, nor would they ship until Heller assumed the payment of the invoices. Thus, in equity, there is considerable basis to conclude that there was no antecedent debt; and, further, that no depletion of assets of the bankrupt occurred through the transfers of cash credits for raw materials received.

In wrestling with such problems, the courts have in

similar cases reasoned that payments to third-parties on account of the debtor, such as the accounts payable purchased here, merely substitutes creditors and do not constitute preferences, and are subject to set-off by the payer. Thus, a stock-broker who held stock for a customer and grain accounts against him was allowed to set-off the debts as mutual even though not arising out of the same transaction. In re Rosenbaum Grain Corp., supra at (5). The endorser of a note of an insolvent debtor was allowed to set-off the amount of the note against a claim for services by the debtor against him. Abercrombie v. Brinkman, 293 F. 375 (4th Cir. 1923). The surety-company on a bond was allowed to set-off an insurance property damage claim against its bond liability. Hayden v. Standard Accident Insurance Co., 316 F.2d 598 (9th Cir. 1963). The situation is less clear where a person in the position of guarantor or surety, *without prior consent of the debtor,* uses funds or property of the debtor in his hands to satisfy a liability to another creditor Miller v. Fisk Tire Co., 11 F.2d 301 (D.C. Minn. 1926); Lytle v. Andrews, 34 F.2d 252 (8th Cir. 1929); Manufacturers Acceptance Corp. v. Hale, 65 F.2d 76 (6th Cir. 1933); Shapiro v. Royal Indemnity Co., 224 F.2d 89 (3rd Cir. 1955). In each of such instances, however, the application of funds without consent was for an antecedent debt and depleted the assets of the estate available for other creditors. Here as seen, Heller simply held debits and credits of accounts receivable and accounts payable of $118,581.56 which it owned outright and was, in equity, entitled to set them off against the other.

By the provisions of Section 68 of the Bankruptcy Act (11 U.S.C.A. § 108), a creditor which has outstanding obligations to a bankrupt may set-off the obligation which the creditor owes to the bankrupt against claims

which the bankrupt's trustee makes against the creditor. This privilege of allowing a creditor to so set-off an obligation owing from the creditor to the bankrupt has been recognized in American Bankruptcy law since 1800. 4 Collier, Bankruptcy ¶ 68.01 [1] at 703 (14th ed. 1964). Obviously, the use by a creditor of section 68 set-off, places that creditor in a preferred position with respect to other general creditors which are not indebted to the bankrupt estate. Nevertheless, this preferred treatment is expressly sanctioned by section 68 of the Bankruptcy Act. One leading bankruptcy treatise has characterized such a preference as a "legal preference," 3 Collier, Bankruptcy ¶ 60.15 at 827 (14th ed. 1964), and another while recognizing that set-off transaction "prefers" such a creditor categorically states that such a result has been repeatedly sanctioned by the courts. "There can be no serious doubt that a right of set-off in a debtor of the bankrupt who is also a creditor gives him an advantage over other creditors. If the debt due such debtor was paid by the bankrupt while insolvent and within four months of bankruptcy, the payment would ordinarily constitute a recoverable preference. By using the amount due as a set-off, the debtor-creditor gets the full benefit of it notwithstanding his debtor's insolvency. But this is immaterial. The equities are not against a set-off merely because of the fact of advantage to one who is a debtor, as well as a creditor, of the bankrupt." 2 Remington Bankruptcy ¶ 1434.5 at 376-77.

The purpose of section 68 "is to make it unnecessary for a creditor to pay the bankruptcy estate the full value of a claim he owes the bankrupt, while at the same time being allowed only partial satisfaction of a claim due him from the estate." United States v. Brunner, 282 F.2d 535, 537 (10th Cir. 1960).

As stated, there is less certainty regarding the DuPont accounts, where Heller's liability was technically contingent as guarantor. In point of fact, the transactions with DuPont were handled in almost the same fashion as the other suppliers, the only difference being that title did not pass and no factor's fee was collected from DuPont. The same arguments for "non-preference" and "set-off" could seemingly be advanced on the facts as in the case of the other suppliers. However, in view of what follows, an absolute determination of such question is not necessary.

It is concluded that, at all times under investigation, Heller was a secured creditor for all sums due it for the accounts payable and the guaranteed accounts, as well as for direct loans and interest due. The particular language of the various security instruments has been set out in these findings (See notes 1, 2, 3, 4 and 6). Suffice it to say, they are broad, whether they reach the judicial "dragnet" status or not. In bankruptcy matters, the determination of secured position and the rights thereunder are dependent on state law. Benedict v. Ratner, 268 U.S. 353, 45 S.Ct. 566, 69 L.Ed. 991.

Thus, it is possible for a security creditor under the same instrument to be in a favorable position in one state and in an unfavorable position in another, when it comes to bankruptcy of his debtor. Compare Hulsart v. Hooper, 274 F.2d 403 (5th Cir. 1960, Alabama) with James Talcott, Inc. v. Wilcox, 308 F.2d 546 (5th Cir. 1962, Florida). See also: Perkins v. Lakeport Nat'l Bank, 139 F.Supp. 898 (D.N.H. 1955). The open-end clauses of the collateral notes and security deeds (Notes 1, 3, and 4) are clear. The actual assignment of the accounts receivable does not specifically provide that they secure "any other indebtedness."

However, the factoring agreement of November 16, 1962 (See note 2) and the letters of October 23, 1963 (See note 6) attached to the receivables assigned. Insofar as the four-months period is concerned, they were prior assignments of the account current and unequivocal direction to use such funds for the specific purposes of satisfaction of suppliers' accounts, the DuPont account, and any principal and interest payments due on the collateral notes.

There is little doubt that Georgia is a "creditor's state", and it falls in that group of jurisdictions which give the fullest effect to open-end clauses. Thus, the Georgia Supreme Court states: "In other words, it is a well established principle of law in this State that a grantor may convey property, real or personal, for the purpose of securing a present, past, or future indebtedness, this being a matter of private contract; and this court has previously said that courts should always guard with jealous care the rights of private contract, and give to them full effect when it is possible to do so. This is a duty which rests upon principles of highest importance, for the security and integrity of the business world depends upon it." Rose City Foods v. Bank of Thomas County, 207 Ga. 477 at 481, 62 S.E.2d 145 at 148. See also: Leffler Co. v. Lane, 146 Ga. 741, 92 S.E. 214; Hurst v. Flynn-Harris-Bullard Company, 166 Ga. 480, 143 S.E. 503. There is no question that the prior assignment under Georgia law extends to claims acquired from third parties. Rose City Foods v. Bank of Thomas County, supra; Vidalia Production Credit Assn. v. Durrence, 94 Ga.App. 368, 94 S.E.2d 609.

It is, therefore, concluded that the obligations of Bemporad to reimburse Heller for payments made and liabilities accrued pursuant to the guaranties and

commitments issued by Heller to the suppliers were liabilities within the scope of the cross collateral future advance provisions contained in each of the security agreements, security deeds and bill of sale to secure debt executed by Bemporad and delivered to Heller, and the collateral subject to all such security instruments, duly and properly secured against the Trustee each such liability of Bemporad arising out of the guaranties and commitments issued by Heller from the time such guaranties and commitments were made by Heller. The giving of security by Bemporad to Heller prior to or concurrently with guaranties or commitments by Heller is not a preference under section 60 of the Bankruptcy Act. Trustee relies on Miller v. Fisk Tire Co., 11 F.2d 301 (D.Minn. 1926); but in that case the collateral was given to the guarantor after the guaranty had been made.

Any finding of fact contained in these conclusions of law shall be deemed a finding of fact for all purposes.

Trustee is not entitled to recover from Heller and the costs of this action should be taxed against Trustee. Heller shall deposit with Trustee $12,714.31 for further disposition by the Referee in Bankruptcy.

There has been no contest here over the accounting by Heller of the funds in its hands or those obtained from foreclosure after bankruptcy, and this ruling, while controlling on the Referee on legal principles, shall in no way preclude on examination by him on the correctness of the charge-backs or the proper application of any funds by Heller, if they are contested.

While the result reached here is undoubtedly disappointing to the Trustee and to the general credi-

tors of the bankrupt after their aggressive and thorough action, an opposite finding would make commonplace services offered to industry extremely hazardous to factors. Factoring services are a necessity to many businesses. To penalize by subsequent bankruptcy of the debtor a factor who carries out the good faith agreements of his customer would relegate the use of factors to those organizations so financially secure that they are not needed. Admittedly, there is some premium on diligence by a creditor, but the purpose of the Bankruptcy Laws is not to equalize all creditors regardless of their priority, but only to preserve equality among creditors of the same class.

It is so ordered.

APPENDIX B

Statutes Involved

(1) Section 60a of the Bankruptcy Act, 11 U.S.C.A., § 96a provides:

(a) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition in bankruptcy, or of the original petition under chapter 10, 11, 12, or 13 of this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class. For the purposes of subdivisions a and b of this section, a transfer shall be deemed to have been made at the time when it became so far perfected that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, and, if such transfer is not so perfected prior to the filing of the petition in bankruptcy or of the original petition under chapter 10, 11, 12 or 13 of this title, it shall be deemed to have been made immediately before bankruptcy.

(2) Section 60b of the Bankruptcy Act, 11 U.S.C.A., § 96b provides:

(b) Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the

property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however,* That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

(3) Section 68 of the Bankruptcy Act, 11 U.S.C.A., § 108 provides:

a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

b. A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under subsection g of section 93 of this title; or (2) was purchased by or transferred to him after the filing of the petition or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy.

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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1967.

No. 1148.

WALTER E. HELLER AND COMPANY,
Petitioner,

vs.

CHARLES C. SHAW, Trustee in Bankruptcy for
Bemporad Carpet Mills, Inc.,
Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

I. THE PETITION IS NOT WITHIN THE SCOPE OF SUPREME COURT RULE 19.

The petition for a writ of certiorari should be denied, for the reason that the instant case does not come within the scope of Rule 19 of the Rules of the United States Supreme Court. The reason assigned in the Petition, namely: that there is a conflict between the circuit courts of appeal; is not supported by the record. Nor does the

case present any "special and important reasons" for a review on writ of certiorari, as required by Rule 19.

The case here involved is a simple preference action brought by a trustee in bankruptcy to recover certain voidable preferential transfers, pursuant to Sections 60 (a) and (b) of the Bankruptcy Act (11 U. S. C. A., § 96). The defense asserted is the right of set-off under Section 68 (a) of the Bankruptcy Act (11 U. S. C. A., § 108 (a)).

Both the claim asserted by the trustee and the defense interposed by Walter E. Heller & Co. involve the application of established principles of law, and neither issue requires clarification by the United States Supreme Court.

II. QUESTION PRESENTED.

Respondent is of the opinion that the question presented, as stated on page 2 of the Petition, is an oversimplification and is therefore inaccurate. The question is more properly stated as follows:

> "Where a factor, within the four month period prior to bankruptcy, receives certain accounts receivable from the bankrupt, for which the factor gives no present consideration but merely posts a credit balance in the factoring account, and thereafter the factor debits the aforementioned account to satisfy antecedent indebtedness that the bankrupt owes to the factor, can the factor avoid liability to the trustee in bankruptcy by invoking the defense of set-off when all of the elements of a voidable preferential transfer are present?"

III. STATEMENT OF THE CASE.

The statement of the case presented in the Petition is incomplete, and Respondent therefore presents the following additional summary.

Pursuant to the factoring agreement between Walter E. Heller & Co. and Bemporad Carpet Mills, Inc., Bemporad transferred and assigned its accounts receivable to Heller, who established an account on its books in Bemporad's name, which account was in the nature of a bank checking account except that only Heller could draw checks on it. As receivables were transferred by Bemporad to Heller, this account was credited in the face amount of the receivables, and from time to time Heller would debit the account to pay itself for interest charges, service charges, and for the payment of supplier accounts that Heller had guaranteed to and/or purchased from companies that were supplying raw materials to Bemporad. (See page 3 of Petition, including footnote.) A credit balance in this account represented a debt due from Heller to Bemporad for accounts receivable transferred to Heller but not paid for. The factoring agreement did not require that Heller pay any certain amount to Bemporad at any certain time as consideration for the assigned accounts receivable, and the procedure followed was for Heller to forward cash sums to Bemporad as requested and as available. Therefore, this account that Heller maintained for Bemporad was not strictly a reserve account. It was simply a general account containing all credits and all debits, representing the total receivables assigned to Heller by Bemporad, the total cash advancements to Bemporad, and all charges made by Heller against the account.

The first day of the four month period prior to bankruptcy was November 19, 1963. On that date Bemporad owed Heller over $168,000 for supplier invoices dated as

early as September. During the four month period Bemporad transferred $700,000 worth of receivables to Heller, but Heller only advanced $370,000 to Bemporad as present consideration therefor, leaving $330,000 worth of accounts not paid for. Because bankruptcy ensued at the end of this four month period, this $330,000 item represented either a fraudulent transfer under Section 67 (d) (2) (a) of the Bankruptcy Act or a preferential transfer under Section 60 (a) (1). Heller's records show that the $330,000 credit balance was appropriated by Heller for the purpose of satisfying the following indebtedness due from Bemporad to Heller, namely: the aforementioned $168,000 that was already due at the commencement of the four month period, and $119,000 in supplier accounts and interest charges that accrued during the four month period. The payments of antecedent debts represent preferential transfers, and all other payments represent fraudulent transfers.

Insofar as the preferential transfers are concerned, the trustee had the burden of proving the seven elements required by the Bankruptcy Act. (See **Mayo v. Pioneer Bank**, 270 F. 2d 823.) All of these elements, except insolvency and reasonable cause to believe insolvency, were stipulated at the pre-trial hearing and at the commencement of the trial itself as evidenced by the following excerpt from the record:

> "Mr. Morgan: Well, as far as the Trustee's burden of proof, the issues are insolvency, and reasonable cause.
>
> "The Court: That's right. Is there any dispute about that?
>
> "Mr. Gowen: No, sir."

During the trial Heller stipulated insolvency, and it also stipulated that it had reasonable cause from January 9, 1964 to the filing of the bankruptcy petition on March 18, 1964.

The District Court made a specific finding that Heller had reasonable cause during all of the four month period. (See A 27 of the Petition.)

The Fifth Circuit ruled that the evidence fully supported the District Court's finding that all of the elements of a voidable preference had been proved. (See A 2—first paragraph.) The Fifth Circuit then ruled against Heller's defense of set-off on two grounds: First, because Heller had received preferential transfers and was therefore barred by Section 68 (b) from using a set-off (A 6 and A 7); and, Second, because Heller was seeking to set-off against the Trustee the very payments that had been found to be voidable preferences. (A 12 of the Petition).

The statement of the case, as set forth on pages 2 through 5 of the Petition, presents a distorted picture of the transactions that gave rise to the trustee's claim.

The first distortion arises from the use, on page 3, of the words "purchased" and "purchase". Walter E. Heller & Co. purchased nothing. Some $330,000.00 worth of accounts receivable were transferred and assigned to Heller by the Bankrupt **during the four month period**, for which Heller gave no present consideration whatsoever. At least $287,000.00 was subsequently applied by Heller to pay itself for antecedent debts owing by the Bankrupt. The situation is analogous to that of **Commercial Credit Corp. v. Sorgel**, 274 F. 2d 449, 466 (5th Cir., 1960), wherein it was stated:

> "Howard transferred a substantial amount in accounts receivable to Commercial Credit after August 26, 1953, for which Commercial Credit did not advance any additional money. It cannot be said, therefore, that such accounts were 'purchased'." (See footnote on page A 2 of the Petition.)

The second distortion arises from the statements, on pages 4 and 5, that the Fifth Circuit held that the collec-

tions of the accounts and the set-offs against the factoring reserve constituted the voidable transfers. The Fifth Circuit did not so hold. The holding was that the preferential transfers consisted of the assignment and transfer of accounts receivable without present consideration, which accounts were thereafter applied to the payment of antecedent debts. In the "Order Denying Motion for Rehearing", the Fifth Circuit stated its holding as follows:

> "Bemporad delivered over to Heller some $700,000 in accounts during the four-month period preceding bankruptcy. $287,000 of these accounts was stipulated by Heller to have been applied on antecedent debts. Although Heller prefers to call the fund from which the $287,000 came a 'factoring reserve', it was made up of accounts receivable of Bemporad delivered over to Heller during the four month period. This delivery over or transfer, or whatever it might be called, when coupled with the application of accounts to antecedent debts, resulted in a transfer under § 60 a." (page A 11 of the Petition.)

The statement on page 4 of the Petition that "These set offs against the factoring reserve are the transfers which the Trustee alleged . . . to be voidable preferences", is not a true statement. In the complaint filed by the Trustee against Heller on October 8, 1964, it was alleged in the third and fourth paragraphs that "During the four month period . . . the bankrupt transferred to Walter E. Heller & Company . . . accounts receivable". It was therefore clear from the very beginning that the transfers sought to be avoided as preferences were those assignments of accounts receivable made by the Bankrupt to Heller during the four months prior to bankruptcy. Of course, the diversion by Heller of some $287,000 from the Bemporad account to itself in payment of antecedent debts was the culmination of the preferential transfers, but it was the

transfer and assignment from Bemporad to Heller during the four month period that actually constituted the voidable preferential transfers.

An additional distortion appears in the first full paragraph on page 5 of the Petition where it is stated that "Thus, in effect, the Fifth Circuit treated as decisive the time when the accounts were assigned." Nothing could be further from the truth. The Fifth Circuit opinion never mentioned the collection of the accounts, and the opinion makes it clear that it is the **assignment and transfer** of the accounts that created the preferential transfer (A 7 and A 11). If these transfers had not been subsequently applied to the payment of antecedent debts they would have been recoverable by the Trustee under Section 67 (d) as fraudulent transfers. Their application to the payment of antecedent debts simply served to categorize the transfers as preferential rather than fraudulent.

The ruling of the Fifth Circuit was:

1. "There is no question but that the evidence was substantial to support the finding that the trustee proved the elements necessary to establish the transfers as voidable under Section 60a" (page A 2 of Petition). (Even the District Court ruled that all of the essential elements of a voidable preference had been established. See pages A 6, A 13 and A 14, and A 1 where this fact is noted by the Fifth Circuit); and

2. Heller is not entitled to assert the right of set-off under Section 68 of the Bankruptcy Act because "by application of Section 68b(1), this advantage is available only to a creditor who has a claim that can meet the requirements of 57g of the Bankruptcy Act. . . . It follows that a creditor may not defend against the receipt of otherwise voidable preferences by asserting the right of set-off under Section 68 . . ."

IV. THE FIFTH CIRCUIT DECISION DOES NOT CONFLICT WITH ANY DECISION FROM ANY OTHER CIRCUIT.

1. The decision in the case at bar does not conflict with the Eighth Circuit case of **First Natl. Bank v. Julian**, 383 F. 2d 329, cited at pages 6 and 7 of the Petition. In the **Julian** case the Bank set off a checking account, designated as "Reserve Account", against a debt due to the Bank by the Bankrupt (p. 332). The Circuit Court held that this account was "a general checking account" (p. 337) and that "The account constituting a general deposit is subject to the Bank's right of set off . . ." (p. 338). There was no intimation by the Eighth Circuit that the checking account was made up of voidable preferential transfers, as is the situation in the Fifth Circuit case. The Fifth Circuit also recognizes the established rule of bankruptcy law set out in **Julian**, that a bank can set off a deposit received in good faith and in the regular course of business. **McKee v. Hood**, 312 F. 2d 394 (1) (5th Cir., 1963). In the **Julian** case, if the checking account had been created by voidable preferential transfers, the Eighth Circuit would necessarily have denied the right of set off, in line with the ruling in **Mechanics Bank v. Ernst**, 231 U. S. 60, 67, that "The so-called deposit . . . rightly was held to be a payment and a preference. A set-off properly was denied." There is no conflict at all between the Eighth Circuit and the Fifth Circuit on the question of a set-off under Section 68 of the Bankruptcy Act.

2. The Fifth Circuit decision is not in conflict with the Second Circuit decision in **Wolf v. Aero Factors Corp.**, 221 F. 2d 291, cited on page 6 of the Petition. On the contrary, the **Wolf** case is in support of the Trustee's position in the case at bar, involving a factual situation almost identical to that here involved. In **Wolf** the District Court had permitted the factor to set off against

certain non-preferential items, **but** the Court then held, at 126 F. Supp. 872, 882, as follows:

> "The word 'transfer' in the statute is used in its most comprehensive sense, and is intended to include every means and manner by which property can pass from the ownership or possession of a debtor to a creditor and by which the 'preference' forbidden by the Statute may be accomplished. **Pirie v. Chicago Title & Trust Co.**, 182 U. S. 438. . . . In the case at bar the bankrupt must have acquiesced in the deductions from the amounts due him and in the application of those sums to antecedent debts. Such conduct constituted a preferential transfer and the trustee is entitled to recover the $2,259.70 thus transferred."

The Second Circuit affirmed, and with regard to the items allowed as a set-off the Court held, at page 292:

> "Accordingly, **there being no preference**, the 'mutual debts or mutual credits' rule of Section 68 of the Bankruptcy Act, 11 U. S. C. A., § 108, was applicable" (emphasis added).

In the Fifth Circuit case under discussion, there was a preference, and therefore no set-off can be allowed.

3. The Fifth Circuit decision is not in conflict with the "implied holding" of the Tenth Circuit in **Porter v. Strevell-Paterson Finance Corp.**, cited on page 7 of the Petition. The **Porter** case did not involve any question of preferential transfers, and the Circuit Court did not deal with that point. The decision is totally irrelevant to the issues involved in the Fifth Circuit case.

4. The Fifth Circuit decision is not in conflict with the District Court decision in **Pasadena Investment Co. v. Pasadena Air Products, Inc.**, cited on page 7 of the Petition. Unlike the case at bar, the transfers in **Pasadena** were not voidable preferences. The Court there held at pages 134 and 135, as follows:

"Further, that such a preference may be avoided only if the transferee . . . had reasonable cause to believe that the debtor was insolvent. . . .

"Moreover, the evidence fails to establish that PIC had reasonable cause to believe that either PAP or Bradford were insolvent at the time of the factoring."

The Court there denied recovery to the Trustee because the Trustee failed to carry his burden of proving that the transfers were preferences as defined by Section 60 of the Bankruptcy Act. In the case at bar, all seven elements of a voidable preference were either proved by the Trustee or stipulated by Heller. (See A1 and A2 of the Petition.) Therefore, the ruling in **Pasadena** is irrelevant to the issues in the Fifth Circuit decision.

5. The Fifth Circuit decision follows the provisions of Section 60 of the Bankruptcy Act, and the case law based thereon, in holding that the transfer by the Bankrupt to Heller of $287,000 worth of accounts receivable without any present consideration, within four months of bankruptcy, when Heller knew that the bankrupt was insolvent, and which Heller used to pay itself for debts owed to it by the Bankrupt, constituted a voidable preferential transfer. No other correct legal ruling could have been made on the facts in this case. The Court then followed established bankruptcy law in denying Heller's defense of set-off.

V. HELLER IS NOT ENTITLED TO AN EXEMPTION FROM THE PROVISIONS OF SECTIONS 60 AND 68.

On page 11 of the Petition the statement is twice made that the Fifth Circuit held that the time when the accounts are collected determines the time of transfer. The Fifth Circuit did not so hold. The Court's opinion makes it crystal clear that it was the **transfer** of accounts during

the four month period that formed the basis for the Trustee's recovery. The issue regarding collection of the accounts was and is totally irrelevant, was never argued by the Trustee, and was never ruled on by either Court. The Fifth Circuit simply held that Heller did not give present consideration for the accounts so transferred to it and therefore it is liable to the Trustee under Section 60.

The plea is made, at pages 10 and 11 of the Petition, that the Fifth Circuit decision will adversely affect the factoring business and that therefore Heller should not be required to return the voidable preferences to the Trustee.

Heller's plea for exemption from the provisions of the Bankruptcy Act can best be answered by a quotation from the decision in **Corn Exchange Natl. Bank & Trust Co. v. Klauder**, 318 U. S. 434, 437 (1943):

> "Such a construction is capable of harsh results, and it is said that it will seriously hamper the business of 'non-notification financing', of which the present case is an instance. This business is of large magnitude and it is said to be of particular benefit to small and struggling borrowers. Such consequences may, as petitioners argue, be serious, but we find nothing in Congressional policy which warrants taking this case out of the letter of the [Bankruptcy] Act."

The dire prediction made at page 11 of the Petition, that the Fifth Circuit decision will severely limit the availability of factoring, is pure conjecture. Moreover, it asserts a conclusion that is not warranted by past events. As early as 1942 the Second Circuit ruled that a trustee in bankruptcy could recover from a factor the value of accounts receivable assigned by the bankrupt within the

four months preceding bankruptcy, where same were shown to be voidable preferences. See **Swetman v. Edmund Wright Ginsberg Corp.**, 128 F. 2d 1, 4 (cert. denied, 317 U. S. 647, 63 S. Ct. 42). The Southern District of New York, in the heart of the factoring industry, has held accordingly in **In Re Ace Fruit & Produce Co.**, 49 F. Supp. 986 (7) (1943), and in **Wolf v. Aero Factors Corp.**, 126 F. Supp. 872 (22) (1954). In spite of these decisions, and in spite of the fact that the Bankruptcy Act itself grants no exemption to factors from the effects of Sections 60 and 67, the factoring industry has prospered. The Fifth Circuit decision does not change existing law, nor does it introduce any new legal principle. It merely follows the plain language of the Bankruptcy Act. It is therefore difficult to accept Heller's prediction of disaster if this decision is left in effect.

VI. THE ISSUE OF SET-OFF IS A FALSE ISSUE.

Heller, at page 5 of its Petition, refers to Section 68 (a) of the Bankruptcy Act and thereby seeks to create the impression that it has a claim that entitles it to a set-off under that Section. The record shows, however, that Heller does not have, and never has had, a claim that was within the purview of Section 68. For that reason Heller's claim of set-off is a false issue in this case.

Heller's position, as set forth in its brief filed with the Fifth Circuit, is that during the four month period Bemporad owed Heller a large sum of money, and when Bemporad delivered the aforementioned accounts receivable to Heller there was thereby created a debt from Heller to Bemporad, and Heller then set off the one debt against the other. That position is factually correct, but it is not a Section 68 set-off. This is the type of transaction that was condemned by the Seventh Circuit in **Froehling v. Amer. Trust & Savings Bank**, 177 Fed. 194

(2) (1910), where it was held that a purchaser of property from a bankrupt within the four month period cannot set off the purchase price against a debt due to him by the bankrupt.

Moreover, it is well settled that a creditor cannot set off, against the trustee's claim for recovery of preferences, the very debts that the preferences satisfied. **Walker v. Wilkinson**, 296 Fed. 850 (4), 852 (5th Cir., 1924). In the case at bar, Heller satisfied $287,000 worth of indebtedness, and it is this same $287,000 that is being asserted as a set-off against the trustee's claim.

In addition, Section 68 speaks only of "mutual debts". It is established law that the statutory liability of a preferred creditor to surrender the preference to the trustee in bankruptcy is not a "debt" within the meaning of Section 68. **United States v. Roth**, 164 F. 2d 575 (6, 7) (2nd Cir., 1948); **In Re American Creameries**, 90 F. Supp. 618 (3), 622 (S. D., Tex., 1950); and **In Re Majestic Radio & Television Corp.**, 227 F. 2d 152 (5) (7th Cir., 1955).

The effect on the bankrupt estate is the same, whether Heller simply took the assigned accounts and applied them in payment of antecedent debts, or whether it first credited the value of the receivables to the Bemporad account and then debited the account, utilizing what it calls a "set-off". In either event Heller gets $287,000 for nothing, and the bankrupt estate sustains a loss of $287,000.

Applicable in either event is the ruling in **National Bank of Newport v. Nat. Herkimer County Bank**, 255 U. S. 178, 184, 32 S. Ct. 633, 635 (1912), that it is the effect of the transfer that determines the preference, and not the mere form or method pursued.

VII. CONCLUSION.

The decision of the Fifth Circuit being legally sound, and the matter not falling within the purview of Rule 19 of the Supreme Court Rules, the Respondent respectfully requests the Court to deny the Petition.

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Certificate of Service.

I do hereby certify that I have this day mailed in a properly stamped envelope a copy of the foregoing Brief to Charles L. Gowen, Trust Company of Georgia Building, Atlanta, Georgia 30303, attorney for Petitioner.

This 19th day of March, 1968.

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Oscar M. Smith,
Attorney for Respondent.